FOR ARGUMENT

Supreme Court, U. S.
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No. 76-1359

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

BANKERS TRUST COMPANY,

Petitioner,

v.

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER BANKERS TRUST COMPANY

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November 25, 1977

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REPLY BRIEF FOR THE PETITIONER BANKERS TRUST COMPANY

In our main brief, we have shown that the Second Circuit erred in reversing Judge Pollack and holding that Respondents had standing to maintain an action against Bankers Trust under Section 10(b) and Rule 10b-5, because a pledge of securities as collateral for an indebtedness is not a "purchase" or "sale" within the meaning of the Act. We have likewise shown that Bankers Trust's release of a pledge of collateral to its borrower Kates related to repayment of the indebtedness and was not "in connection with" the loan transactions between the plaintiffs and third-parties.

The brief of the Respondents Mallis and Kupferman (hereinafter referred to singly as "Mallis") and the Amicus Brief of the Securities and Exchange Commission (hereinafter "SEC") employ factual distortions and legal fallacies to confuse and circumvent the legal issues set forth in Bankers Trust's main brief. Accordingly this brief reply is necessary.

1. The pending State Court actions against Bankers Trust

Both Mallis and the SEC urge that an action under Section 10(b) and Rule 10b-5 is necessary because the State Court action was dismissed (Mallis brief, pages 10, 14-16, SEC brief, page 3). Both fail to point out that in this case, as in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, that the State Court actions, to which Bankers Trust is a party, are still pending involving ordinary questions of fact. (*Blue Chip Stamps*, 421 U.S. at 738, fn. 9). Although the action was originally dismissed against Bankers Trust, two defendants therein, Jack J. Arnold ("Arnold") and John B. Fowler, Jr. ("Fowler"), instituted third-party actions which are still pending in the State Court. (See our main brief, fn. 9, pages 11-12, fn. 23, page 37). In attempting to allow Mallis and Kupferman, as pledgees of the securities from Arnold and Fowler, to expand the concept as to who may sue under Section 10(b) and Rule 10b-5, Mallis and the SEC seek to "permit a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence . . ." *Blue Chip Stamps*, 421 U.S. at 741.

Over the vigorous opposition of Mallis and his attorney, the State Court directed Mallis to appear for an examination before trial in that action and produce for examination by Bankers Trust the signed depositions of Fowler and of Arnold. A copy of the order of the State Court entered on May 27, 1977 (four days after certiorari was granted in this case) is reproduced in the appendix to this reply brief *infra* App. 12-16.[1] Similarly, Bankers Trust was granted the right in the State Court action to examine Fowler, again after vigorous opposition of Fowler's attorney. That order was granted on July 7, 1977. That examination was held on notice to the attorneys for all parties, including Mallis. The testimony demonstrated beyond question that the allegations with respect to Bankers Trust, whether in the State or Federal action, are totally without merit. Although the facts brought forth in the Fowler deposition are not important to the ultimate disposition of the question here involved, those facts are significant in showing that this action is simply one, where, as in *Blue Chip* the "in terrorem" threat of a securities fraud action is being utilized in an attempt to bludgeon a settlement from Bankers Trust.

2. The factual misstatements in the Mallis and SEC briefs

Both Mallis and the SEC in their briefs make assertions that are not supported by the record and which are in fact contradicted by both the Record and Fowler's testimony, both in 1973 and his more recent examination of October 13, 1977.

1. Although stating that the record is unclear with respect to the act of Bankers Trust's representative, the

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[1] ("A.") refers to the appendix heretofore filed with the Court. ("App.") refers to the appendix at the end of this brief. Fowler EBT refers to the examination of John B. Fowler, Jr. on October 10, 1977.

SEC flippantly characterizes it as the "misrepresentation". (SEC brief, page 5). This is contrary to the position that Mallis and Kupferman have long taken in the State Court proceeding (A. 68, 70 and 75). It is likewise contrary to the testimony of John Fowler. Fowler testified that the alleged false affidavit was dictated by Arnold, relying on the answers to questions given by Kates. Any suggestions made by the Bankers Trust representative were "more the editorial than the substantive." (Fowler EBT, pages 114 to 118). Thus, contrary to the statement in Mallis's brief, the Kateses affidavit was prepared by Mallis's own attorney, Arnold.

2. In an attempt to create innuendos of fraud, the SEC asserts that the closing was attended by "Arnold and Fowler, the Kateses and a representative of Mallis and Kupferman." (SEC brief, at page 4). Mallis and Kupferman's own version of the facts differ from that of the SEC. Mallis states that "Arnold, the attorney, and Murfitt, a vice president of the Franklin National Bank", were the representatives. (Mallis brief at page 4). Certainly the Commission should at least accept Mallis and Kupferman's own version of who their representative was instead of attempting to pervert the facts to satisfy a legal result.

3. The SEC asserts that Mallis and Kupferman "would not have made the loan had they known that the collateral designed to secure it was worthless paper." (SEC brief, pages 15-16). This assertion flies in the face of the agreement between Arnold and Fowler and Mallis whereby they expressly did not expect to be repaid from the Equity National stock, which had been pledged, but were going to be "reimbursed" from the transfer during March, 1972 of "a block of 100,000 shares of Merck & Co." (A. 49, 75). Indeed Fowler's testimony very clearly shows that the parties relied on the Merck stock and not the Equity National stock. Fowler stated that Equity National "wasn't the sort of stock you should put good money into," but "this fascination stemmed from the pot of gold at the end of the rainbow, which was the Merck stock." (Fowler EBT at 27).

4. The assertion by Mallis that Bankers Trust failed to disclose that Equity National instituted a lawsuit against Bankers Trust is likewise baseless. (Mallis brief, fn. 4, page 4) Fowler in his testimony, which Mallis sought to avoid producing in the State Court action, admitted that he did not rely on Bankers Trust but he had contacted the National Bank of Georgia, the transfer agent, with respect to the existence of any restrictions on the stock. He was informed by the National Bank of Georgia—on two separate occasions—that the only restriction on the stock was the legend. Similarly, Fowler testified that on February 28, 1972, he had contacted Childs, the president of Equity National, who informed Fowler that "they were suing Kates, that the agreement had been dissolved and the stock would not be transferred." (Fowler EBT 86). Arnold, Mallis's representative, was made fully aware of these facts by Fowler (Fowler EBT 86-88). The only question asked of Bankers Trust was whether it would deliver the securities (A. 114). Since Bankers Trust had not been sued and since Silverman did not know of any lawsuit, he merely stated that Bankers Trust would return the collateral to Kates for redemption. If Mallis and the SEC have any complaints about the lack of disclosure, that lack of disclosure was not by Bankers Trust—which had no contact with Mallis and Kupferman—but by Arnold and Fowler.

3. A pledge is not a sale under the Uniform Commercial Code and State Law

The SEC states (at its brief p. 21) that "a pledge is . . . a 'sale' under . . . the Uniform Commercial Code (and) other state law."

To the contrary, the Uniform Commercial Code does not include pledge relationships within its definition of "sale", which "consists in the passing of title from the seller to the buyer for a price." UCC Sections 9-105(3), 2-106(1). "Purchase" under the Code is defined broadly, because the term is used for a different purpose, and includes "taking by sale . . . , mortgage, pledge . . . gift or any other voluntary transaction creating an interest in property." UCC Section 1-201(32). However the term "purchase" is never used in Article 9 of the Uniform Commercial Code, which is the only Article dealing with the creation, validity and extinction of pledges. In fact, the Code expressly exempts pledgees from "contract or tort liability upon the secured party for the debtors acts or omissions", precisely the claim plaintiffs press herein. UCC Section 9-317.

The "other state law" referred to by the SEC turns out to be a 1932 case of doubtful validity from a lower federal court. In all events, that court was interpreting the California "Blue Sky" statute, which had a different definition of "sale" than that found either in the 1934 Act or at common law. See SEC brief at 22; *Cecil B. DeMille Productions* v. *Woolery*, 61 F.2d 95 (C.A. 9, 1932).

4. Under the 1934 Securities Exchange Act, a pledge of securities is not a purchase or sale

In its zeal to impose the antifraud provisions of the securities laws upon all commercial loan transactions in which securities are pledged as collateral, the SEC essentially ignores the decisive question—whether a pledge of securities involves a "purchase" or a "sale".

The SEC argues that "because of the generality" of the definitions of "purchase" and "sale" in the 1934 Act, the focus "is not on the definition, but on the broader issue whether Bankers Trust's "alleged conduct is the type of fraudulent behavior which was meant to be forbidden by the statute and the rule.'"[1] (SEC brief at page 14). The SEC then concludes that the antifraud provisions should apply because this case "charges only a garden variety type of fraud, based upon a misrepresentation of the type courts traditionally have resolved." (SEC brief at 28-29, 16).

But Section 10(b) and Rule 10b-5 require that the fraud be in connection with the "purchase or sale" of securities, not merely be in connection with any transactions involving securities. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975). If there is no "purchase or sale" of securities, then there is no cause of action under Section 10(b) and Rule 10b-5 for alleged securities fraud. *See id.* at 760 (Powell, Jr., concurring): "It may well be conceded that *Birnbaum* does allow some fraud to go unremedied under the federal securities Acts." *See also id.* at 738.

The definitions of "purchase" and "sale" in the 1934 Act are not, contrary to the assertion by the SEC, too "general". The terms are carefully defined in the 1934 Act to be themselves. See *Blue Chip Stamps*, *supra*, at 733 n.5: The 1934 Act is a "carefully drawn statute [that] itself defines the term 'sale.'" The fact that the terms are defined

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[1] The SEC purports to quote *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180 and *Tcherepnin* v. *Knight*, 389 U.S. 332, in support of its position that pledges are encompassed within the 1934 Act definition. Neither case however has anything whatsoever to do with whether a pledge is a "purchase" or "sale". *Tcherepnin* does not involve any issues even arguably analogous to those here. In *Capital Gains*, the court held only that an exchange of shares as a result of a merger was a "purchase or sale" because it involved a transfer of ownership "like a typical cash sale or share exchange." *Id.* at 466.

to "include" contracts to purchase and sell only adds executory as well as executed purchases and sales—as this Court has stated, there is no cause of action under Section 10(b) "when there is no actual purchase or sale of securities, or a contract to purchase or sell, affected or tainted by a violation of § 10(b)." *Id.* at 735.

In arguing the generality of the 1934 Act definitions, the SEC finds comfort in the residual clauses "otherwise acquire" and "otherwise dispose of." But the SEC's characterization of a pledge of securities as a "disposition" of them imputes to the clause its broadest possible sense, so that it includes any transfer of physical possession. Such an interpretation flies in the face of the "commonly accepted meanings" of the "ordinary words" "purchase" and "sale", which require transfer of ownership. See *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 at 199; *Blue Chip Stamps, supra*, 756 (Powell, Jr., concurring): *SEC* v. *Sterling Precision Corp.*, 393 F.2d 214, 217-18 (2d Cir. 1968) (Friendly, J.).

The SEC cites numerous transactions which federal courts have held were encompassed within the terms "purchase" and "sale"—"mergers, issuance of stock, forced sales, and exchanges of shares" (SEC brief at 20-21; footnotes omitted). All those transactions, however, involve precisely the element missing in a pledge transaction—transfer of ownership. As discussed in our main brief at pages 17-18 and the Clearing House brief at pages 5-7, a pledgee does not own, or even have a contingent right to own, the pledged property. Even upon default, the pledgee's right to sell the collateral is only as agent for, and for the account, of the pledgor.[8]

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[8] A "purchaser" of securities acquires at least four important indicia of ownership: 1) the right to enjoy an increase in the value of the securities; 2) the right to receive dividends; 3) the right to vote the securities; 4) the right to dispose of the securities when, and to whom, the owner wishes. A pledgee of securities acquires not one of these rights.

The SEC also seeks to equate the definition of "sale" in the 1934 Act with the definition in the 1933 Act, which includes transfers of an "interest in a security," and then argues that a pledge of a security involves transfer of an "interest" in it. However, leaving aside the questionable interpretation of the 1933 Act definition, the SEC's argument leads to the opposite conclusion. According to this Court, because the 1934 Act is a "carefully drawn statute [that] itself defines the terms 'sale'" that should be contrasted "with Congress' separate definition and use" of the term in the 1933 Act. *Blue Chip Stamps*, at 733 fn. 5.

As a policy justification for Section 10(b)'s coverage of pledges, the SEC implies that the parties to a pledge transaction otherwise would be functionally remediless. But the parties to a pledge transaction, unlike a purchase or sale, rarely need resort to an action for fraud. By the nature of the transaction, the pledgor has an absolute contractual right to return of the collateral upon repayment. And the pledgee ordinarily need not resort to a fraud action because he always has an action on the note. In all events, in the rare case in which a fraud action might serve some purpose, state law causes of action are readily available.

The SEC tips its hand when it asserts parenthetically that "investors" is a "category which includes lenders" (SEC brief at 16). Never has this Court ever held or otherwise intimated that lending, like "investing", is regulated as a matter of course by the securities laws. A holding to that effect would vastly expand the scope of the securities laws and would do so without any support in the legislative history of the securities acts.

A pledge transaction does not involve a "purchase" or "sale" between the pledgor and pledgee, and for that rea-

son is not within the scope of Section 10(b) of the 1934 Act.[4]

Conclusion

For these reasons and the reasons set forth in our main brief, the judgment of the Court of Appeals should be reversed, and the judgment of the District Court dismissing the complaint against Bankers Trust Company should be reinstated.

Respectfully submitted,

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Counsel for Petitioner,
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New York, New York 10019

November 25, 1977

[4] In an attempt to muddy the important legal question herein involved, the SEC makes erroneous bold statements. (a) Thus the SEC asserts that Bankers Trust statement that "banks were specifically exempted from any provision of the securities laws (Br. 30) is erroneous." The SEC does not point out that this is a direct quotation from this Court in *Radzanower* v. *Touche Ross & Co.*, 426 U.S. 148 at 157. (b) The SEC relies upon lower court cases such as *SEC* v. *National Bankers Life Insurance Company*, 477 F.2d 920 (CA 5, 1973) and *American Bank and Trust Co.* v. *Joste*, 323 F.Supp. 943 (WD Louisiana, 1970) (SEC Brief, page 30). These cases were relied upon by Mrs. McClure, and expressly rejected, by the Fifth Circuit in holding that a pledge was not a sale for purposes of a civil damage action under Section 10(b) and Rule 10b-5. See *McClure* v. *First National Bank of Lubbock Texas*, 497 F.2d 490, 495 (C.A. 5, 1974) *cert. denied* 420 U.S. 930 (1975).

SUPPLEMENTAL APPENDIX

Order of State Court in Pending Action.

Present: HON. ARNOLD L. FEIN, Justice.

SAMUEL MALLIS

against

JEROME B. KATES, et al.

The following papers numbered 1 to read on this motion, submitted.

	Papers Numbered
No. 52 on Calendar of Mar. 21—1977.	
Notice of Motion—Exhibits and Affidavits Annexed	1–4
Answering Affidavit	5
Replying Affidavits	6–8
Exhibit	9

Upon the foregoing papers this motion is decided in accordance with accompanying memorandum decision.

ALF
J. S. C.

Dated May 26 1977

SUPREME COURT : STATE OF NEW YORK

COUNTY OF NEW YORK : SPECIAL TERM PART I

INDEX No. 25831/72
No. 52 of Mar. 21/77

SAMUEL MALLIS,

Plaintiff,

against

JEROME B. KATES, JUDITH KATES, JACK J. ARNOLD, JOHN B. FOWLER, JR.,

Defendants.

JOHN B. FOWLER, JR. and JACK J. ARNOLD,

Defendant and Third-Party Plaintiff,

against

BANKERS TRUST COMPANY,

Third-Party Defendant.

FEIN, J.:

Motion by plaintiff for a protective order vacating the demand for production of documents and the notice of deposition heretofore served by third party defendant Bankers Trust Company is granted only to the extent that items 3 through 6 of Banker's notice of discovery, and the corresponding items in the notice of examination are vacated as lacking necessary specificity, and is otherwise denied.

Contrary to plaintiff's apparent suggestion, a third party to the action is not in an inferior position in the conduct of disclosure and pretrial proceedings. Under applicable rules, such a party is a party for all purposes. Nor is the filing of a note of issue and statement of readiness dispositive of the issue raised under the circumstances. It appears that the action was marked off the calendar by Justice Levy after the case had been assigned to I. C. Part 4. The case, therefore, is not on the calendar at this time and, under applicable rules, discovery may be conducted. Equally lacking in merit is the suggestion that the transcripts of examinations before trial and the exhibits used and marked for identification thereat constitute the work product of counsel.

Nevertheless, items 3 through 6 of the discovery notice do not identify the documents to be produced with sufficient particularity as required by appropriate court rules. Nor is there any reason shown to vary from the normal procedure by first conducting examinations before trial to ascertain the existence of identifiable documents before an appropriate notice to produce is served pursuant to CPLR 3120.

Plaintiff shall appear and submit to examination before trial to be held at Special Term Part 2 on July 5, 1977 at 10 A.M., said examination to continue from day to day until completed. Within ten days prior to that date, plaintiff shall produce the documents responsive to items 1 and 2 of Bankers' notice to produce. This disposition is without prejudice to the service of an appropriate notice of discovery after the existence of identifiable documents has been made known upon the deposition to be conducted as herein directed.

Serve a copy of this order with notice of entry without undue delay.

Dated: May 26, 1977

ALF
J S C

Demand for Production of Documents.

SUPREME COURT OF THE STATE OF NEW YORK

COUNTY OF NEW YORK
Index No. 25831/72

SAMUEL MALLIS,

Plaintiff,

—against—

JEROME B. KATES, JUDITH KATES, JACK J. ARNOLD, JOHN B. FOWLER, JR.,

Defendants.

JOHN B. FOWLER., and JACK J. ARNOLD,

Defendant and Third-Party Plaintiff,

—against—

BANKERS TRUST COMPANY,

Third-Party Defendant.

PLEASE TAKE NOTICE that third-party defendant Bankers Trust Company hereby requires plaintiff, Samuel Mallis to produce for inspection and copying, pursuant to Rule 3120 of the Civil Law and Rules at the offices of Charles Leeds, Esq., 1775 Broadway, 12th Floor, New York, New York 10019 (212) MU 2-5888 on Wednesday, March 16, 1977 at 10:00 A.M. the following documents:

1. The signed examination before trial of John B. Fowler, Jr. dated September 12, 1973 and continued on

September 18, 1973 and the documents annexed thereto, including the following:

(a) 1972-1973 diary of John B. Fowler, Jr.

(b) All records and reports of J.S. Love & Co.

(c) Rescision agreement

(d) Diary of telephone calls from Love & Co.

(e) Letter agreement of April 25, 1972.

(f) All checks issued by John B. Fowler, Jr. to Samuel Mallis, Jerome B. Kates and Dr. Franklyn Kupferman.

(g) All correspondence sent from John B. Fowler, Jr. to Samuel Mallis.

2. The signed examination before trial of Jack J. Arnold taken by the attorneys for Samuel Mallis and or documents referred to therein.

3. All correspondence between Samuel Mallis and Jack J. Arnold, Jr. from the period of 1970 to and including March 2, 1977 whether written by Samuel Mallis or his attorneys on his behalf to Jack J. Arnold, Jr.

4. All correspondence between Samuel Mallis and Jerome B. Kates or Judith Kates during the period from February 1, 1972 to and including March 2, 1977, whether the correspondence was written directly by Samuel Mallis or his attorneys on his behalf to Jerome B. Kates and Judith Kates.

5. All papers filed and affidavits submitted on behalf of Samuel Mallis in any 10b5 action instituted in his behalf whether that action was in the Southern District of New York or the Eastern District of New York.

6. All settlement agreements between Samuel Mallis and Jerome B. Kates and Judith Kates, Jack J. Arnold and John B. Fowler and William London.

Dated: New York, New York
March 3, 1977

Yours, etc.,

Charles Leeds, Esq.
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Bankers Trust Company
1775 Broadway
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(212) MU 2-5888

To: Max Kaplan, Esq.
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